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In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTHWEST EXPLORATION COMPANY, A CORPORATION.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross in-

In the Supreme Court of the United States

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v.

SOUTHWEST EXPLORATION COMPANY, A CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 75-104) are reported at 18 T. C. 961. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 21-29) is reported at 220 F. 2d 58.

JURISDICTION

The judgment of the Court of Appeals (Ap-

pendix B, *infra*, pp. 29-30) was entered on March 7, 1955. By order of Mr. Justice Douglas, dated May 27, 1955, the time for filing a petition for a writ of certiorari was extended to August 4, 1955. (Appendix B, *infra*, p. 30.) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Taxpayer obtained a lease from the State of California to drill for and produce oil from certain submerged lands. By state law, taxpayer was required to drill the wells on a slant from uplands adjacent to the coastal area and, as a condition to obtaining the lease, taxpayer was required to secure necessary easements from the upland owners permitting it to conduct the drilling and production operations from and through their property. In return for securing such easements from certain upland owners, taxpayer undertook to pay them 24½ percent of its net profits derived from the extraction of oil from the submerged lands.

The question is whether taxpayer's depletable interest includes the net profit payments which it made to the upland owners, as was held by the court below, or, on the contrary, whether the upland owners are entitled to depletion deductions on these payments to the exclusion of taxpayer, as was held by the Court of Claims in a companion case involving one of the upland owners.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations (Sections 23 (m) and 114 (b) (3) of the Internal Reve-

nue Code of 1939, Sections 6873-(a) and 6874 of the Public Resources Code, Deering's California Codes (1944), and Section 29.23(m)-1 of Treasury Regulations 111) are set forth in Appendix A, *infra*, pp. 17-21.

STATEMENT

The undisputed facts in this case may be summarized as follows:

In 1938, the State of California passed the State Lands Act of 1938 to control the exploitation of oil deposits in the lands belonging to the state. (R. 109.) The Act (now part of the Public Resources Code) provided (*infra*, p. 18) that any lease of submerged state land shall contain a provision that—

> Each well drilled pursuant to the terms of [the] lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease.

The lease was further required to provide that all machinery be located on, and all surface operations be conducted from, such filled lands or uplands. (*ibid.*)

From August 8 to 13, 1938, the State Lands Commission published a "Notice of Intention of State Lands Commission to Receive Offers to Enter into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State, Situate in

Orange County, California" (hereinafter referred to as the "Notice"). (R. 5-6, 21-24, 79.) The area covered by the Notice consisted of approximately 835 acres of submerged land lying off Huntington Beach, California. (R. 79.) There were no "filled lands" usable or available in connection with the extraction of oil and gas from this area. (R. 8, 90.)

The Notice stated that each bidder, as a condition precedent to consideration of his bid, had to present satisfactory evidence of his ability to furnish all necessary sites and rights-of-way. This evidence was to include (1) an endorsement by the owners of the uplands on the proposed agreement acknowledging that the bidder had the necessary sites, rights-of-way and easements, and (2) the originals, or copies, of the instruments vesting in the bidder the necessary sites, rights-of-way and easements. (R. 21-22.)

On August 25, 1938, taxpayer entered into an agreement with the owners of the uplands adjacent to the 835 acres of submerged land covered by the Notice. These owners were the Huntington Beach Company, the Pacific Electric Railway Company, the Pacific Electric Land Company, the Bolsa Land Company, the Bolsa Chica Gun Club, and the Standard Oil Company of California. Under this agreement taxpayer was permitted to go on the uplands, to open the tops of its oil wells from the uplands, to drill into the land and under the land, and to place its machinery on the surface of the lands. (R. 6, 89). A second, contemporaneous agreement

between taxpayer and four of the upland owners covered the surface location and subsurface course of the wells to be drilled through the uplands owned by these owners. (R. 9, 49-58, 89-90).

On August 30, 1938, taxpayer submitted its bid to the State Lands Commission. (R. 7, 79-80.) It annexed to its bid a form of "Agreement for State Easement" which bore the following endorsement by each of the upland owners (R. 7, 47-48):

> Endorsement of Uplands Owner
>
> The owner or owners of real property described in this agreement as the "uplands" hereby acknowledge that the Grantee named in this agreement has been granted all necessary rights-of-way and easements, in and through the uplands necessary for the performance upon the part of the Grantee of the covenants, and the observance upon the part of the Grantee of the conditions, herein set forth, and the said owner or owners hereby consent to all operations upon the uplands specified and contemplated by the provisions of this agreement.

Also attached to the bid was the agreement giving taxpayer permission to use the uplands for its drilling operations. (R. 7, 80.)

On September 26, 1938, taxpayer's bid was accepted and it entered into "Agreement for State Easement No. 392". (R. 8, 24-49, 80.) This agreement, as required by the State Lands Act of 1938, contained a provision requiring all wells to be slant

drilled from the uplands and requiring all machinery to be located on, and all operations to be conducted from, such uplands. (R. 35.)

The following day, September 27, 1938, taxpayer entered into a third agreement with the Pacific Electric Railway Company, the Pacific Electric Land Company, and the Huntington Beach Company. (R. 59-74, 90.) The stated purpose was to "provide a manner of computation and distribution of rental for the rights and privileges" given by these upland owners and others to the taxpayer in the two agreements entered into on August 25, 1938. (R. 60.) The agreement provided that taxpayer should pay the other parties to the agreement "as rental an amount equal to the following percentages of the 'net profits' " from the extraction of oil from the lands covered by the state easement (R. 68):

17.75 % to Huntington Beach Company,
1.576% to Pacific Electric Railway Company,
5.174% to Pacific Electric Land Company

The agreement contained elaborate provisions governing the calculation of the net profits. These net profits were defined as the "gross proceeds" from the taxpayer's operations on a designated portion of the state lands minus "chargeable expenses." The gross proceeds included the sale value of all oil produced and saved and all gas produced and sold, and 50 percent of the value of all gasoline extracted from gas, minus state royalties, plus the proceeds of rental of equipment, etc., the cost of

which had been a chargeable expense. (R. 62-63.) The chargeable expenses embraced all normal operating costs (R. 64-66.)[1]

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[1] In addition this agreement contained the following provisions (R. 70-71, 72-73):

13. It is understood and agreed that nothing herein shall add to, modify, or limit the privileges given to Southwest by Second Parties and others in those certain agreements dated August 25, 1938, or the rights given to Southwest under said State Easement, nor shall any default hereunder by Southwest cause a forfeiture of the rights or privileges given Southwest by Second Parties under said agreements of August 25, 1938.

14. All operations performed by Southwest in connection with the development and operation of said described lands shall be at the sole cost and expense of Southwest, and Second Parties shall not be chargeable with nor liable for any part thereof. None of the amounts paid to Second Parties hereunder shall be returned to Southwest should there be a subsequent loss in the development and operation of said lands, provided that if said State Easement and the privileges given Southwest under said agreements of August 25, 1938, and referred to herein, are terminated otherwise than as provided therein and a loss results to Southwest therefrom, then each Second Party shall repay to Southwest the following percentages of such loss; as to Huntington Beach Company, 17.75%; as to Pacific Electric Land Company, 5.174%; and as to Pacific Electric Railway Company, 1.576%; provided that none of Second Parties shall be required to pay, in any event, more than has been received by such Second Party hereunder.

* * * * *

19. This agreement shall not be construed to give Second Parties any right, title or interest in said State Lands or in or under said State Easement, and said Southwest may, at any time, at its election, without any consent or participation by Second Parties, modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof. In the event that Southwest shall assign its interest in State Easement, such assign-

All surface operations in connection with the drilling and operation of wells covered by taxpayer's State Easement No. 392 were conducted on the land owned by the Huntington Beach Company. All subsurface operations and wells went through the land of that company and the lands of the Pacific Electric Land Company and the Pacific Electric Railway Company. (R. 15.)

During the taxable years in question, 1939-1945, 24.5 percent of the net profits were paid the Huntington Beach Company, the Pacific Electric Railway Company and Pacific Electric Land Company, pursuant to the agreement of September 27, 1938. (R. 16, 19-20.)

Determination of taxpayer's federal tax liabilities[2] involved the question whether taxpayer was

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ment shall be made subject to the assumption by the assignee thereunder of all of the obligations of Southwest under this agreement.

* * * * *

22. This agreement and the two said agreements of August 25, 1938, and any and all rights of Southwest in or to the property covered thereby, shall terminate upon the expiration of said Easement No. 392 or any renewals, extensions, or modifications thereof. Upon such termination, Southwest shall proceed diligently to remove any and all facilities which it may have placed upon said uplands and shall forthwith restore said uplands as nearly as possible to the condition in which said premises existed prior to the commencement of operations thereon by Southwest. Southwest shall immediately upon such termination pay to Second Parties whatever sums of money which may then be due them.

23. It is the express intention of the parties hereto not to create a partnership relationship.

[2] The taxes involved are income, declared value excess profits and excess profits taxes.

required (as asserted by the Commissioner) to exclude from its gross income, on which percentage depletion was allowable, the net profit payments made to the upland owners. The Tax Court, reasoning that the upland owners did not acquire any depletable interest by virtue of the net profit payments, held that taxpayer was not required to exclude those payments from its depletion base. (R. 97-104.) The Court of Appeals affirmed in a *per curiam* opinion which adopted relevant extracts from the Tax Court's opinion. (Appendix B, *infra*, pp. 21-29.)

REASONS FOR GRANTING THE WRIT

1. The decision below is in direct conflict with that of the Court of Claims in *Huntington Beach Co.* v. *United States*, decided July 12, 1955, in which a petition for a writ of certiorari is also being filed. The two courts have reached opposite conclusions as to which of two taxpayers is entitled to percentage depletion on the same income from the identical oil property. The income in question consists of a portion (24½ percent) of the net profits earned by the lessee of the wells, which it undertook to pay to adjoining landowners for the privilege of drilling the wells slantwise through their property. The Ninth Circuit, on the express assumption that the upland owners are not entitled to the depletion deduction on the net profit payments received by them from the lessee, held that the taxpayer-lessee is entitled to compute its deduction without excluding these payments from its depletion base; the Court of Claims, on the express

assumption that the lessee must exclude the net profit payments from its depletion base, held, contrariwise, that the upland owners were entitled to depletion deductions on the payments which they received from the lessee.

Section 114(b)(3) of the Internal Revenue Code of 1939 (Appendix A, *infra*, pp. 17-18), which provides that percentage depletion shall be "27½ per centum of the gross income from the property during the taxable year," has been held to grant a "single depletion allowance" (*Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321) which must be apportioned among and shared by all parties having a depletable interest in a particular mineral property. *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 604; *Helvering* v. *Twin Bell Syndicate*, *supra*; *Anderson* v. *Helvering*, 310 U.S. 404, 407.

Consequently, if the Court of Claims is correct in holding that the payments to the upland owners constituted "gross income from the property," entitling them to depletion computed under Code Section 114 (b)(3), it is obvious that the lessee's "gross income from the property" cannot include the same amounts and that the court below was wrong in holding that they were available to the lessee for computation of its depletion deduction. Conversely, if the court below is correct, then it is plain that the Court of Claims is wrong in permitting the upland owners to have the deduction. In short, one or the other—either the lessee or the upland owners—is entitled to the deduction. Since

both cannot be entiled to the same deduction, either the Ninth Circuit or the Court of Claims has reached an erroneous result.[3]

2. Since the court below and the Court of Claims have permitted different parties to have what is, in effect, the very same deduction on the same income from the identical property, it is plain that, unless reviewed by this Court, the conflicting decisions of these courts will become final and the Government, because of principles of estoppel by judgment, will be compelled to permit both taxpayers to continue to have the deduction in all future years while oil is being produced from these wells. This, of course, would represent an indefinite, annual windfall to which one of the taxpayers cannot be entitled and would result in an unwarranted loss to the revenue each year.[4] This can be avoided only by the intervention of this Court.

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[3] In the *Huntington Beach* case, the Court of Claims, referring to the decision of the court below, said: "If that decision is correct, the plaintiff cannot prevail in this case. It is not legally permissible for both companies to have the same deduction."

[4] The present case involves a disputed tax liability of approximately $175,000 for the taxable years in issue. In the *Huntington Beach* case, *supra*, involving only one of the upland owners for the single year 1948, the tax refund, exclusive of interest, was $135,000. In addition, there is now pending in the United States District Court for the Northern District of California, Southern Division, a suit by the United States against Huntington Beach Company for erroneous refund based on the fact that Huntington Beach claimed and was allowed to deduct in its returns for 1942 through 1946 depletion on the net profit payments which it received from Southwest in those years. The United States seeks the recovery of more than $500,000 in that suit.

3. The conflict, moreover, is the result of divergent views concerning the meaning of the decisions of this Court in *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, which held that, in the circumstances of those cases, an interest in the lessee's net profits from the production of oil was depletable by the recipients, and the decisions in *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, which held that, in the circumstances of those cases, an interest in the lessee's net profits from the production of oil was not a depletable interest. The different conclusions which the court below and the Court of Claims have drawn from these cases in deciding the issue presented here reflect uncertainty concerning the proper application of this Court's decisions.[5]

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[5] See 4 Mertens, Law of Federal Income Taxation, Sec. 24.21, c. 24, p. 61; Baker, The Nature of Depletable Income, 7 Tax L. Rev. 267, 281-284 (1951-1952); Modesitt, Capital Gains on Oil and Gas Transactions, 27 Rocky Mt. L. Rev. 39, 44-49, 53 (1954); Note: Taxation of Net Profit Interests in Oil Properties, 56 Yale L. J. 170 (1946).

CONCLUSION

There is a clear and direct conflict of decisions. The question presented is of importance because it involves, in substantial amounts, protection of the federal revenue and because there is uncertainty in the lower federal courts as to the criteria which govern application of the Code provision permitting allowance for depletion. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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AUGUST, 1955.

come an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 114.)

Public Resources Code, Deering's California Codes (1944):

Sec. 6873. *Form of Lease: Preparation and Contents.* The commission shall prepare a form of lease which shall contain, in addition to other provisions deemed desirable and necessary by the commission, appropriate provisions contained in this chapter and the following:

(a) Each well drilled pursuant to the terms of the lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease. The derricks, machinery, and any and all other surface structures, equipment, and appliances shall be located only upon filled lands or upon the littoral lands or uplands, and all surface operations shall be conducted therefrom.

* * * * * *

Sec. 6874. *Notice of Intention: Requirement of Evidence of Ability to Furnish Sites and Rights of Way.* In any notice of intention to lease tide or submerged lands, the commission may include a requirement that each prospective bidder, as a condition precedent to the consideration of his bid and in addition to the other qualifications required by this chapter, shall present evidence satisfactory to the commission of his present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease. In such event the commission shall reject the bids of all bidders who fail to qualify as provided by this section.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.* — Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral

in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

(b) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

* * * * *

(i) "The property," as used in section 114 (b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. * * *

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 13,875

March 7, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY, A CORPORATION, RESPONDENT

On Petition to Review a Decision of the Tax Court of the United States

Before: STEPHENS, Circuit Judge, CHAMBERS, Circuit Judge, and HARRISON, District Judge.

Per Curiam:

In this appeal, the only question brought to us from the Tax Court is who is entitled to depletion for oil that is extracted from beneath the ocean. The Tax Court held that upland owners from whose lands the slant wells were drilled into the pool of oil, under the ocean, are not entitled to participate

in the depletion for oil thus extracted. The Commissioner of Internal Revenue appeals asserting that the upland owners, comprising the Huntington Beach Co., Pacific Electric Ry. Co., Pacific Electric Land Co., The Bolsa Land Co., the Bolsa Chica Gun Club, and the Standard Oil Co., upon whose lands the wells were drilled and through whose property the rights of way and easements were granted for the drilling of such wells are entitled to a portion of the depletion for oil extracted under the permit granted by the State to the taxpayer.

We are in accord with the ruling of the Tax Court [1 T.C. 961] and adopt that part of the Tax Court's opinion reading as follows:

> "The second question involves petitioner's right to a depletion deduction on the 24½ per cent of its net profits which it paid to certain upland owners. It was on and through the property of these owners that petitioner had located various 'whipstock' wells for the production of gas and oil from the submerged lands located adjacent thereto.
>
> "As pointed out above, petitioner acquired the sole right to exploit the oil property in question by virtue of its 1938 agreement with the State of California. The terms of this agreement provided that any development of, or drilling into, the submerged lands covered thereby must be conducted from littoral or upland sites. This provision required as a condition precedent to the agreement that the requisite easements be procured from the owners of the adjacent uplands and that certification as

to such action then be made in the form of an endorsement by the upland owners attached to the agreement as finally executed. In consideration of the necessary easement and certification petitioner agreed to pay to the upland owners involved an amount equal to 24½ per cent of its net profits.

"Petitioner seeks to include the foregoing amount within its gross income subject to a deduction for depletion in accordance with sections 23(m)[2] and 114(b)(3),[3] Internal Revenue Code.

"In order to determine whether petitioner is entitled to include the above amount within its gross income and then be allowed the depletion claimed, we would briefly recall the pur-

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[2] Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

[3] Sec. 114. Basis for Depreciation and Depletion.

* * * * * *

(b) Basis for Depletion.—

* * * * * *

(3) Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year; excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

pose and intent of the statutory allowance. Because of their inherent nature, oil and gas reserves, together with other mineral deposits, have been recognized and designated as wasting assets. Anderson v. Helvering, 310 U.S. 404. By this designation it is meant that a portion of the capital assets is consumed in the production of income through exploitation thereof. Helvering v. Bankline Oil Company, 303 U.S. 362. Hence, Congress has granted the deduction in question as an equitable means of allowing a tax free return of the capital so consumed in the process of production. Anderson v. Helvering, supra. It follows that the depletion deduction is allowable only to those who have a capital investment or economic interest in the oil or other mineral in place from which income is received by reason thereof. Kirby Petroleum Company v. Commissioner, 326 U.S. 599; Burton-Sutton Oil Co., Inc. v. Commissioner, 328 U.S. 25; Helvering v. Bankline Oil Company, supra; United States v. Spalding, 97 F. 2d 701. In determining whether a taxpayer has such an investment or interest no significance attaches to the particular legal form of the transaction creating the rights. Burton-Sutton Oil Co., Inc., v. Commissioner, supra; Palmer v. Bender, 287 U.S. 551; Lynch v. Alsworth-Stephens Co., 267 U.S. 364. It is enough that the taxpayer has acquired through any form of legal relationship the right to share in the oil produced. Palmer v. Bender, supra. And a right to share in the profits from the sale of the oil

following extraction is analogous to a right to share in the mineral itself. Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312; Anderson v. Helvering, supra; Kirby Petroleum Company v. Commissioner, supra; Burton-Sutton Oil Co., Inc. v. Commissioner, supra. However, the term 'economic interest' does not embrace a '* * * mere economic advantage derived from production through a contractual relation to the owner by one who has no capital investment in the mineral deposit * * *.' Helvering v. Bankline Oil Company, supra. On the contrary, it appears clearly that an allowance for depletion is warranted only where, by agreement between the parties, the taxpayer has obtained a capital interest in the oil and gas in place, to the severance and sale of which one must look for the return of capital consumed in that process. The right to share in the net receipts disassociated from an economic interest therein does not entitle the holder thereof to an allowance for depletion. Kirby Petroleum Co. v. Commissioner, supra; Burton-Sutton Oil Co., Inc. v. Commissioner, supra; Anderson v. Helvering, supra; Helvering v. O'Donnell, 303 U.S. 370.

"In the instant case, it cannot be gainsaid that petitioner possessed an economic interest in the oil involved. The dispute arises as to whether petitioner was the sole owner of such an interest during the taxable years. Petitioner contends that it acquired and has retained the entire economic interest conveyed under the Agreement for State Easement No. 392. Respondent, on the other hand, rejects

petitioner's contention and argues on brief that the upland owners, by their endorsement of the Agreement for State Easement No. 392, became parties thereto; that such owners thereby acquired an economic interest in the oil and gas in place directly from the State; that the income received therefrom by the upland owners is includible in their gross income, rather than that of petitioner, subject to the depletion deduction here in dispute.

"We have no desire or purpose to enter into the dispute as to the claims to rights in the submerged coastal areas (see U.S. v. California, 332 U.S. 19 [1947]) and what we say herein is not intended in any way to pass upon the competing interests asserted in that litigation or growing out of the cited decision.[4]

"Prior to 1938 the State allowed such oil property as is here involved to be developed and operated from piers, islands or barges. In that year the State Legislature passed the so-called State Lands Act of 1938 pursuant to the provisions of which such methods of drilling and development were prescribed. This Act called for each well thereafter drilled in the submerged lands to be drilled from filled lands or slant drilled from an upland or littoral drill

[4] Since the decision in *United States v. California*, *supra*, extraction of oil from the California submerged coastal lands, pursuant to leases previously granted by the State, has been authorized by stipulations executed by the State and the United States. See Hearings before Senate Committee on Interior and Insular Affairs on S.155, 81st Cong., 1st Sess., pp. 279-282; Hearings on S.J. Res. 195, 81st Cong., 2d Sess., pp. 22-26; S.J. Res. 20, 82d Cong., 1st Sess., pp. 13-17.

site. All equipment, derricks, machinery, appliances, surface structures and operations were required to be located upon such site. Section 87(a), Chap. 5, Calif. Stats., Ex. Sess., 1938. This statute was passed as a regulatory measure applying to the development and exploitation of the coastal oil deposits. Obviously, the Act was not meant to convey any economic interests therein to anyone. Nor do we believe that it so did. Consequently, in so far as the 835 acres here involved are concerned, any present economic interests therein were acquired by virtue of, and simultaneously with, the Agreement for State Easement No. 392 or through some transaction subsequent thereto.

"The State and petitioner were the only parties to the body of this agreement. The granting clause therein granted to the petitioner the sole and '* * * exclusive right to drain, take, receive, extract, remove, and produce from the * * * lands oil, gas, and other hydrocarbon substances * * *.' This right is not made subject to any pre-existing rights and there is no provision therein for income derived from oil production to be shared with third parties. Within its four corners, then, it would appear that such economic interests as were passed therein, were acquired by petitioner alone. Nor do we feel that further interests were obtained by other parties outside thereof because of the endorsement attached thereto but not included therein by any reference. There also appears to have been no such acquisition by third parties through any action

on the part of the petitioner. There are in evidence three instruments whereby petitioner acquired the requisite upland easements. In return for such easements the owners thereof were granted the right to 24½ per cent of the net profits derived from petitioner's operations. But we do not feel that such parties thereby acquired a capital interest in the oil in place. One such agreement specifically provides that it shall not be so construed as to be a transfer of '* * * any right, title or interest in [the] * * * State lands or in or under [the] * * * State Easement,' * * *'; and that it was the express intention of the parties thereto not to create a partnership relationship. Further, these parties were never owners nor lessees of the leased property. They did not, and could not, during the taxable years, have produced oil therefrom. Nor did they at any time during the period have any capital investment in the oil or gas in place. Cf. United States v. Spalding, supra. It would seem that the above-mentioned agreements could be terminated or modified at any time petitioner's agreement with the State of California was so terminated or modified. Under these circumstances it would appear that the upland drill sites and the agreements granting them to petitioner could be abandoned and terminated by petitioner at any time the State of California might see fit to change its policy toward drilling in the submerged coastal lands.

"In summation, then, it is our view that petitioner was the sole recipient under the

Agreement for State Easement No. 392 of an economic interest in the oil property involved; that at no time thereafter was any economic interest therein acquired by third parties; that the amounts equal to 24½ per cent of petitioner's net profits were not paid as royalties or rents based upon an economic interest therein; and that therefore, these amounts are includible in petitioners' gross income subject to the statutory allowance for depletion. Accordingly, we so hold. Respondent's claim for increased deficiencies, affirmatively set out in his amended answer, will be considered in the recomputation under Rule 50."

Judgment of the Tax Court from which the appeal was taken is affirmed.

(Endorsed:) Per Curiam Opinion. Filed Mar. 7, 1955. Paul P. O'Brien, Clerk.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 13,875

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY, RESPONDENT

JUDGMENT

Upon petition to review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court in this cause be, and hereby is affirmed.

(Endorsed:) Judgment. Filed and Entered: March 7, 1955. Paul P. O'Brien, Clerk.

SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1954

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 4, 1955.

(S.) WM. O. DOUGLAS,
Associate Justice of the Supreme Court of the United States.

Dated this 27th day of May, 1955.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1955 982668